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TAXATION—INCOME TO BE TAXED MUST BE REALIZED.—In a recent case, the petitioner, a New York corporation, leased land and buildings in 1929 for an original term of twenty-one years, with the contingent option of renewing for three successive like terms in the event that the lessee would build a new building. The new building was completed on May 1, 1931, and by the express terms of the lease title to the building vested in the lessor. The Board of Tax Appeals¹ redetermined a deficiency in the petitioner's taxable income, on the ground that income accrued to the lessor when the building was completed.² The Commissioner added as income the proper aliquot part of the depreciated value of the building—as the lessor's interest must be taken subject to the lease—on the assumption that the controlling term of the lease was twenty-one years and that Article 63 of the Treasury Regulations 74³ was valid. On appeal, *held*, Article 63 was invalid, since it taxed a capital increase and not a realized income.⁴ *Hewitt Realty Co. v. Commissioner of Internal Revenue*, 76 F. (2d) 880 (C. C. A. 2d, 1935).

since reversed by the United States Supreme Court, the taxpayer, a fiduciary, paid a tax on distributions of income payable to the sole beneficiary. Four days prior to the effective date of the Statute of Limitations, the trustees filed a claim for refund. The government found itself barred by the statute from pursuing its rights in an affirmative action against the beneficiary who had never paid a tax on distributions made to her. The government urged the latter fact as a defense in the nature of an equitable set-off or recoupment to the main action. The Court upheld the government in its contention, citing the Bull case and *Connor v. Smith*, *supra* note 8. Taking a realistic viewpoint the Court noted that as the fiduciary paid the tax with money ultimately distributable to the beneficiary, this money may be retained by the government in part discharge of her statute-barred obligation.

¹ 29 B. T. A. 1205 (1934).

² *Miller v. Gearin*, 258 Fed. 225 (C. C. A. 9th, 1919). Held that income was "derived" when the building was first completed. The taxpayer did not have to pay because the Statute of Limitations had run. Not decisive, court cites *Gould v. Gould*, 245 U. S. 151, 38 Sup. Ct. 53 (1917). Where an income tax law is doubtful, the doubt should be resolved in favor of the taxpayer against the Government.

³ REV. ACT OF 1928, §13, 45 STAT. 791, 797; U. S. Treas. Reg. 74, Art. 63.

When buildings are erected or improvements made by a lessee in pursuance with an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

The Commissioner applied subdivision (b).

⁴ *Eisner v. Macomber*, 252 U. S. 189, 40 Sup. Ct. 189 (1920); *North American Oil, Consolidated v. Burnet*, 286 U. S. 417, 52 Sup. Ct. 613 (1932); *Lucas v. North Texas Company*, 281 U. S. 11, 50 Sup. Ct. 184 (1930).

A direct tax must be apportioned according to population.⁵ Taxes upon rents and profits of real estate are in effect direct taxes upon the property from which the income arose.⁶ The Sixteenth Amendment gives Congress power to levy taxes on income without apportionment.⁷ The Court in *Eisner v. Macomber*⁸ defined income, "Not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being 'derived,' that is received or *drawn by* the recipient (taxpayer) for his *separate* use, benefit and disposal, that is income derived from property."⁹

The lessor, the Hewitt Realty Co., received a capital gain¹⁰ by acquisition of title to the new building erected by the lessee. The building became part of the land because so attached as to become part thereof, in law, having a determinate character.¹¹ Only when the premises are sold, is the gain over the lessor's acquired price, taxable income.¹² It is the sale, not the power to sell, from which taxable income is derived.¹³ There are borderline cases concerning what is realized income,¹⁴ predicated on the now settled theory that

⁵ U. S. CONST. Art. I, §2, cl. 3. Direct taxes shall be apportioned among the several states which may be included within the union, according to their respective numbers. Art. I, §9, cl. 4. No capitation, or other direct tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.

⁶ *Pollock v. Farmer's Loan and Trust Co.*, 158 U. S. 601, 15 Sup. Ct. 912 (1894).

⁷ U. S. CONST., Amend. XVI (1913). The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

⁸ *Supra* note 4.

⁹ See *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185, 38 Sup. Ct. 467 (1918).

¹⁰ *Supra* note 4; see *Eisner v. Macomber*, 252 U. S. 189, 40 Sup. Ct. 189 (1920). Example: The growth of trees in a forest is a capital gain; when the trees are cut or separately disposed of we have income. The essential point, it is submitted, is an increase in the *res*, which is not disposable with any reasonableness in respect to objective intent at the time of annexation, adaptability, and detached market value effect both on the *res* and the detached chattel.

¹¹ See N. Y. Laws of 1930, c. 874, N. Y. PERS. PROP. LAW §67; *Kohler Co. v. Brasun*, 249 N. Y. 224, 164 N. E. 31 (1928); *East New York Electric Co. v. Petmaland Realty Co.*, 243 N. Y. 477, 154 N. E. 538 (1926). Court held that wiring attached to building became a part of the building and could not be removed without substantial injury. (Determinate character of realty—part and parcel of the building.)

¹² *Crane v. Commissioner of Internal Revenue*, 68 F. (2d) 641 (C. C. A. 1st, 1934). Held that petitioner's gain over acquired price was taxable income, although his contention was that the Treasury Regulations were valid and that the Statute of Limitations had run. See *Moran v. Commissioner of Internal Revenue*, 67 F. (2d) 601 (C. C. A. 1st, 1933).

¹³ R. H. MONTGOMERY, *INCOME TAX PROCEDURE* (1929) 620; 26 U. S. C. A. 933 a, b, and 935 b.

¹⁴ R. Magill, *When Is Income Realized* (1933) 46 HARV. L. REV. 933, 953.

Congress can tax only income under the Sixteenth Amendment¹⁵ and not capital increases, unless they have been realized.

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¹⁵ *Supra* note 7.